EXHIBIT A.206

(1 of 8)

Report No. 38207-WBG

West Bank and Gaza Public Expenditure Review Volume 2

From Crisis to Greater Fiscal Independence

February 2007

Middle East and North Africa Region
Social and Economic Development Group

Document of the World Bank

CURRENCY EQUIVALENTS
(As of February 2007)

Currency Unit = NIS
$1.00 = NIS 4.23

WBG FISCAL YEAR
January 1 – December 31

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ABBREVIATIONS AND ACRONYMS

GCI	General Control Institute
GHI	Government Health Insurance
GPIC	Gaza Pension Insurance Corporation
MOEHE	Ministry of Education and Higher Education
MOF	Ministry of Finance
MOH	Ministry of Health
MOP	Ministry of Planning
MOSA	Ministry of Social Affairs
MRC	Ministerial Reform Committee
MTDP	Medium Term Development Plan
NHSP	National Health Strategic Plan
ODP	Organizational Development Plan
PA	Palestinian Authority
PCBS	Palestinian Central Bureau of Statistics
PECDAR	Palestinian Economic Council for Development and Reconstruction
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PHC	Primary Health Care
PIF	Palestine Investment Fund
PICCR	Palestinian Independent Commission for Civil Rights
PMA	Palestinian Monetary Authority
RCSU	Reform Coordination and Support Unit
TEI	Tertiary Education Institutions
TIM	Temporary International Mechanism
UNRWA	United Nations Relief and Works Agency

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CHAPTER 1: RECENT MACROECONOMIC AND FISCAL DEVELOPMENTS

1. Key Issues and Challenges

Recent political events have ushered in a period of exceptional uncertainty in the West Bank and Gaza. Hamas' election victory in January 2006 led to a stalemate in political dialogue between the Palestinian Authority government, donors and the Government of Israel. The internal political rift between the two dominant Palestinian factions, Hamas and Fatah, fueled tensions and resulted in intermittent violence, especially in Gaza. After a series of f failed attempts, negotiations to form a coalition government have finally been successful, with an agreement between Hamas and Fatah reached in Mecca in early February 2007. Many donors, chiefly the United States and the European Commission, have imposed anti-terrorist financing legislation on transactions with the PA and ceased all financial support channeled through the PA. The Government of Israel decided to withhold the customs tax and VAT it collects on behalf of the PA. Severe restrictions on the movement of Palestinian people and goods, which the GOI argues are necessary for security reasons, remain firmly in place.

Beset by closures, violence and a fiscal crisis, the Palestinian economy is declining from an already low level. According to preliminary Palestine Central Bureau of Statistics (PCBS) data, real GDP per capita could decline by 8–10 percent in 2006, bringing the cumulative decline in average incomes to over 30 percent since 1999. About a quarter of the Palestinian labor force is out of a job. The situation is particularly tenuous in Gaza, where the unemployment rate increased to 36 percent in 2006, versus 29 percent in 2005. Stepped-up donor support in 2006 played a major role in preventing the economy and household incomes from falling even more rapidly. The economic outlook is precarious. In the short term, continued high levels of donor assistance are critical for sustaining the Palestinian economy. A solid foundation for future growth, however, depends critically on two factors:

- *Radical improvement in Palestinian movement and access.* Under the current set of restrictive measures the Palestinian economy will remain moribund.
- *Stabilization of the PA's fiscal situation.* This would require resumption of the transfer of clearance revenue and a significant fiscal adjustment by the PA.

Even before the present financial crisis, the PA's fiscal situation was unsustainable. The immediate crisis was precipitated by a combination of factors arising in the wake of Hamas' victory in January 2006. These factors include the Government of Israel's decision in February 2006 to suspend the transfer of clearance revenue, which accounts for over 60 percent of the PA's revenues.[1] The PA's past profligate spending policies exacerbate the current crisis. For example, despite a revenue crunch during the *intifada*,

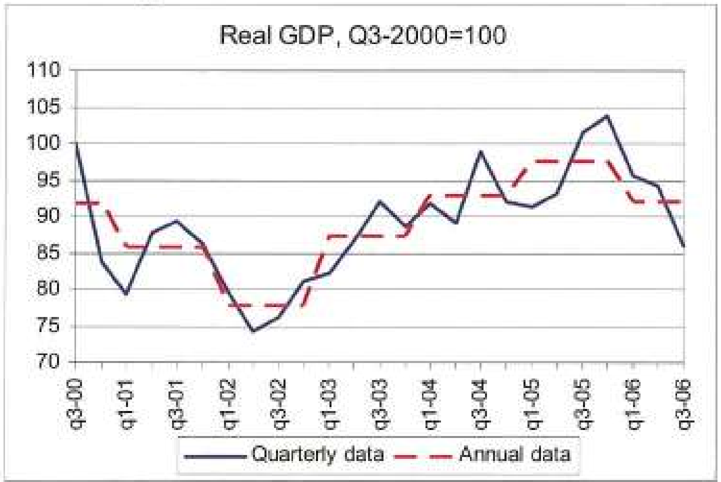
[1] For a description of the clearance mechanism, see *West Bank and Gaza–Economic Developments in the Five Years since Oslo*, by Alonso-Gamo, Alier, Baunsgaard, and von Allman, IMF 1999.

the PA's wage bill increased unabated at a rate of 11 percent between 1999 and 2005. Moreover, since 2003 the PA has increasingly been the "financier of last resort" that covers unmet financial obligations of other public entities (e.g. fuel purchases by the Palestinian Petroleum Commission and electricity purchases by West Bank municipalities). In 2005 such payments drained the public resource envelope by $344 million, or more than 5 percent of GDP. New social benefit programs and pension laws were adopted which have also increased the burden of social transfers for the PA. The resulting increase in the deficit was mostly covered through domestic financing (PIF, bank loans), but this source of financing has reached its limits. Thus, if and when the current crisis is resolved, the PA will still face significant challenges. If they are not addressed, these challenges will be a source of instability and a detriment to future growth.

2. Recent Macroeconomic Trends

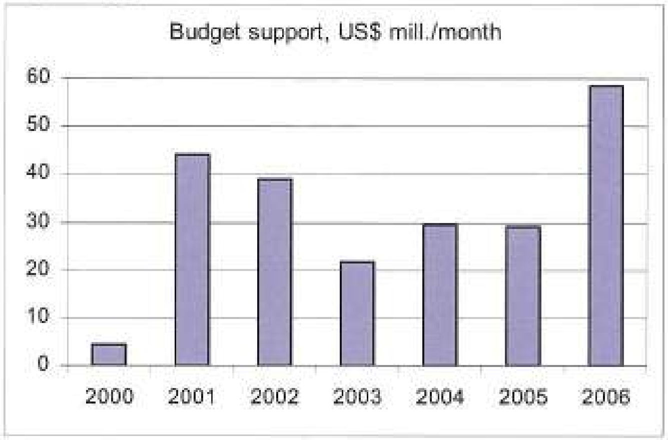
The Palestinian economy is declining. Quarterly GDP data recently released by the Palestinian Central Bureau of Statistics show that GDP (in real terms) declined steadily during the first three quarters of 2006 (figure 1.1).[2] Calculated as an average over the year, the decline is equal to 5–6 percent—adding population growth of 3–4 percent, the decline in per capita GDP amounts to 8–10 percent. This is a sharp reversal of economic trends for the past three years, in which the Palestinian economy recovered from its precipitous decline during the first three years of the *intifada*. A decline of this magnitude would leave GDP per capita around $1,000 and real GDP per capita some 32 percent lower than in 1999.

Figure 1.1: Real GDP Declined in 2006



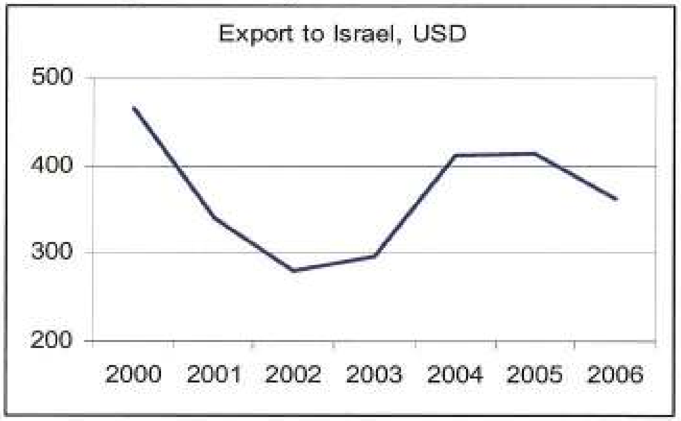
[2] The Quarterly National Accounts data are only preliminary and may be revised later. Due to difficulties on the ground, the quality of the underlying data is deteriorating. PCBS estimates of indirect taxes—which determine the difference between GDP at factor costs and GDP at market prices—is particularly subject to uncertainties, as the clearance revenue is not being transferred.

Figure 1.2: Budget Support from Donors to the Palestinian Authority, 2000–06



Stepped-up donor support has played a major role in sustaining the economy and household incomes. Following the inauguration of the Hamas' government in March 2006, donors were unwilling or unable to provide direct financial flows to the PA government (see discussion below). At the same time, however, donors significantly increased the flow of rapid-disbursing assistance flowing to the West Bank and Gaza through channels outside the government. The IMF estimates that a total of $700 million was provided in budget support in 2006, compared to $349 million in 2005. Data for other types of donor support (emergency/humanitarian assistance, mainly development aid) are notoriously more difficult to measure. Indications are that disbursements of emergency/humanitarian assistance have increased in 2006, while disbursements of development aid have declined.[3] The Bank estimates that $100 million in additional donor support increases Palestinian GDP by 2–3 percent—therefore, the increase in budget support alone may have prevented a further fall in GDP of 8–10 percent.

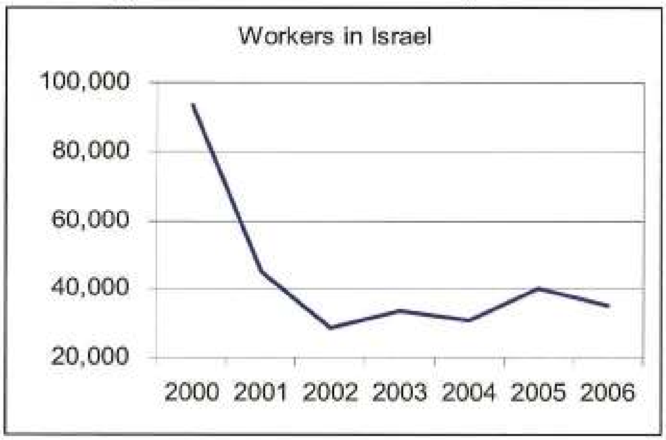
Figure 1.3: Exports to Israel, 2000–06



[3] For example, as of September 30, 2006, the UN's Refugee and Works Agency (UNRWA) had received pledges worth $129 million against their emergency appeal, an increase of 15 percent over the pledges for the full year in 2005.

Closures remain tight, to the detriment of Palestinian export. Movement restrictions and border closures continue to stifle the normal conduct of commercial activities. In interviews for the Bank's forthcoming West Bank and Gaza Investment Climate Assessment more than 60 percent of Palestinian businesses reported that instability and transportation issues are the most important impediments to Palestinian private sector activity. The Bank's ongoing monitoring of Palestinian movement and access shows that the number of trucks carrying exports from Gaza have dropped 40 percent from an already low level at the beginning of 2005, and remain far from the targets set in the November 15, 2005 Agreement on Movement and Access. In their monthly business survey, the Palestinian Central Bureau of Statistics reports that conditions continue to worsen for business owners. In 2005, when economic growth was relatively strong, perceptions leaned toward the positive, with only 10 percent of firms on average indicating month to month that conditions had deteriorated. In 2006, that proportion more than tripled to 34 percent. Palestinian export to Israel, the main market for Palestinian exporters, declined by 15 percent in nominal terms during the first half of 2006 compared to the previous six-month period.[4]

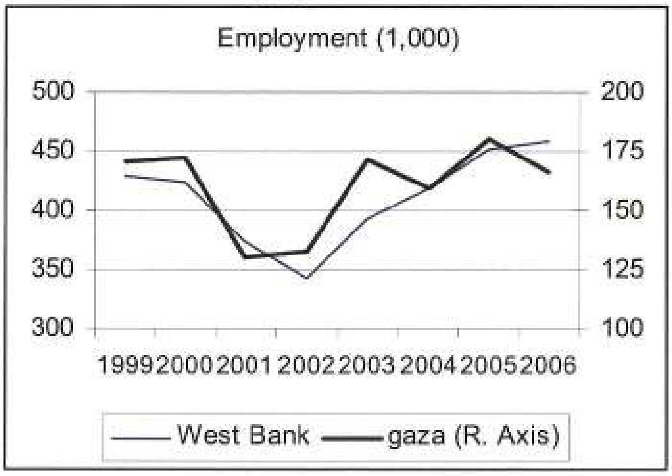
Figure 1.4: Workers in Israel, 2000–06



Movement restrictions have reduced the number of Palestinians working in Israel. An average of 35,000 Palestinians worked in Israel and Israeli settlements during the first six months of 2006, compared to 40,000 in the year 2005—a decline of 12 percent.[5] The decline was especially large for workers without permits, indicating increasing difficulties for clandestine workers in circumventing Israeli checkpoints and other restrictions, including the Separation Barrier. The number of Palestinian workers with permits declined 7 percent. Virtually no Palestinians from Gaza work in Israel anymore.

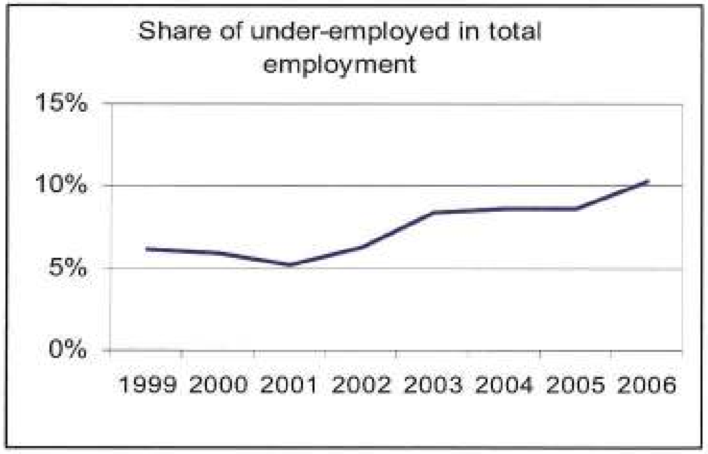
[4] While this is a large decline and an indication of a further tightening of the closure regime, it is still smaller than assumed in the March 15 "Worst Case" Scenario.
[5] The numbers exclude an estimated 24,000 Palestinians residing in East Jerusalem who can work unhindered in Israel.

Figure 1.5: Levels of Employment in the West Bank and Gaza



Although employment declined in Gaza, it held steady in the West Bank. During the first nine months of 2006 the number of jobs in Gaza declined 11.2 percent compared to the same period a year before. Between the third quarter of 2005 and the third quarter of 2006 almost 20,000 jobs were lost in Gaza. At 166,924, the number of jobs in Gaza has fallen close to its level six years ago, on the eve of the *intifada*. The unemployment rate (by ILO definition) in Gaza reached 36.3 percent. By contrast, in the West Bank employment levels during the first 9 months of 2006 have increased moderately compared to the same period a year ago, partly as a result of increased employment in the service, manufacturing and transport sectors. Consequently, the unemployment rate in the West Bank remained roughly unchanged and reached 19.1 percent in the third quarter of 2006.

Figure 1.6: The Share of Under-Employed Workers is Rising, 1999–2006



Increased scarcity of jobs has led to more part-time workers. The share of workers reporting that they work less than full time has increased steadily the past year. In the third quarter of 2006 the share reached 11.6 percent, up from 7.3 percent in the fourth quarter of 2004.[6] Employment data for the fourth quarter of 2006 is scheduled to be released in February 2007. Projections based on the current situation would estimate further job-losses, although the olive-harvest was reportedly exceptional this year, and may have led to an increase in temporary job creation.

According to the IMF (2006), the banking sector remains relatively sound, despite the depressed economy. Private sector deposits continue to grow, albeit slowly, and banks are liquid. While banks have a sizable exposure to the PA and to its employees, the situation should be manageable, at least for the near future. PIF assets guarantee a large part of bank loans to the PA, and the PA employees' debt service obligations currently due are small. Some banks recently deducted small amounts from the latest partial wage payment to government employees to help cover interest due. Banks did not suffer much from the decline in the stock market—a fall of about 50 percent since mid-January 2006—as their exposure was fairly limited and the book values of equity investments had not reflected the substantial gains made prior to the drop in share prices.

3. Fiscal Trends—A Brief Historical Review

In its early years, the PA's revenues increased rapidly. During the five-year period from 1995 (the first full year of the PA's functioning) to 1999, the PA's revenues almost doubled, from $510 million in 1995 to $942 million in 1999. The main driver was a rapid increase in clearance revenue, which reached $580 million in 1999, 62 percent of the total revenues for the year. Domestic revenues also increased strongly, due to the rapid establishment of tax collection capacity in the West Bank and Gaza. By 1999, the revenue-to-GDP ratio had reached 22.6 percent, up from 15.8 percent in 1995 (see table 1.1).[7]

The outbreak of the *intifada* in 2000 and the associated economic crisis had an immediate negative impact on PA revenues. In July 2000, PA revenues reached their pre-*intifada* peak at $95 million. By December 2000—three months into the *intifada*—revenues had declined to $49 million, a decline of roughly 50 percent.[8] The steep decline reflected tightened restrictions on the movement of goods in and out of the West Bank and Gaza, and cutbacks in Palestinian consumer spending, both of which reduced imports. Consequently, fewer trade taxes were collected by the Government of Israel on behalf of

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[6] The number of hours worked by those who report being under-employed is unknown. Assuming that they work half-time, the increase in the share of under-employed has resulted in a 2.2 percent decline in the total number of man-hours.

[7] Following the increase in revenue collection, concerns about transparency in public finances emerged, particularly concerning the diversion of tax revenues to accounts outside the control of the Ministry of Finance, the growth in semiprivate PA investments and the unauthorized revenue collection by various PA entities, notably the security services (Brynen 2005; IMF 2003). Significant improvements in public financial management were carried out from 2002 onward and redressed many of the past deficiencies (World Bank 2004).

[8] These revenue figures include clearance revenue collected by GOI but not transferred during 2001–02.

the PA. The moribund economy kept PA revenues at an average of $52 million per month through 2002. Beginning in 2003 revenues gradually started to recover. By December 2003, revenues (in nominal terms) reached pre-*intifada* levels for the first time.

Box 1.1: Clearance Revenue

The Paris Protocol of Economic Relations of 1994 established the guidelines for a revenue clearance system between the GOI and the PA. Under the operation of the quasi-customs union, Israel collects a duty on foreign imports entering the West Bank and Gaza, as well as a VAT for Israeli products destined to the Palestinians. Indirect tax collection is based on actual payments or bookkeeping transactions and has a unified invoice system to support the claims. For custom duties, VAT, and purchase taxes on third- party goods imported by Palestinian companies for the West Bank or Gaza, a code sharing system ensures the correct amounts are being transferred. Indirect taxes like the VAT are collected and transferred to each side after the reconciliation of accounts and according to a "destination principle." At the end of the month, the PA reports the amount of taxes collected by Israel, and the Israeli administration, conversely reports its share collected by the PA, over which a net claimed is settled. The GOI charges a 3 percent handling fee of the total gross clearance revenue collection.[9] For direct taxes paid by Palestinian workers in Israel and its controlled areas the Protocol established that the income tax collection should be shared by both governments. Therefore, the PA keeps 100 percent of the health fees and receives 75 percent of the income tax under the assumption that workers will most likely consume social services in the West Bank and Gaza.

Clearance revenues were transferred on a monthly basis up to the start of the second *intifada* in 2000. Transfers were suspended by the GOI in December 2000 and only resumed in late 2002. Clearance revenues are the most important source of income for the PA, accounting for two thirds of total revenue (see the table below). Gross clearance transfers amounted to US$757 million for 2005, equivalent to US$63 million per month. Thus, the decision of the GOI to stop transferring clearance revenue by mid – February after Hamas' election victory at the January 25 Parliamentary elections resulted in an average revenue shortfall of about US$ 60 million per month for the PA treasury.

PA revenues (US$ millions)[10]

	2001	2002	2003	2004	2005
Revenue	275	295	763	954	1,233
Domestic revenue	275	223	291	337	476
Tax revenue	183	141	167	191	231
Non tax revenue	92	82	124	146	245
Clearance revenue[11]	0	72	472	617	757

Source: IMF and MOF

The GOI's decision to stop transferring clearance revenue is a violation of the Oslo accords, under which there is no clear provision for Israel to withhold clearance revenues. It is not illegal under Israeli law, which grants such discretion to the Minister of Finance and recognizes international agreements only to the extent that their provisions have been ratified by the Knesset. A case was brought to the Israeli Supreme Court in which the petitioners sought to force the GoI to release the funds. However, the Supreme Court rejected the petition, and in so doing agreed with the GoI that withholding the funds was within the discretion of the Minister of Finance to prevent the funding of terrorist activities. In terms of international law, the issue is open to debate.

[9] West Bank and Gaza Strip: Economic Developments in the Five Years Since Oslo, IMF, November 1999
[10] Economic Monitoring Note, World Bank, Spring 2006
[11] Clearance revenue figures include VAT refunds.

In the initial Oslo period, the PA's recurrent expenditures increased rapidly but were broadly in line with revenues. High initial growth in public expenditures and staffing were expected as a new government apparatus was to be set up basically from scratch. However, the increase also reflected attempts to integrate returning Palestine Liberation Organization employees into the public service and to absorb workers being repatriated, mainly from Gulf countries, in the wake of the first Gulf war and for this reason expenditure growth clearly exceeded what was necessary for the PA to take up its new responsibilities (World Bank 1999). Public employment increased from 57,000 in 1995 to 99,000 in 1999, an annual staffing growth of almost 13 percent.[12] The concurrent growth in the wage bill amounted to approximately 14 percent a year, implying a relatively modest increase in average public salaries of 1–2 percent a year. By 1999 public expenditures amounted to 22.6 percent of GDP, or some $78 million per month, and were fully covered by PA revenues, leaving a balanced recurrent fiscal position.

[12] Thus, in this period, the growth in the public payroll outpaced population growth by more than 2 to 1.

Table 1.1: PA Fiscal Operations, 1995-2005
(millions of dollars)

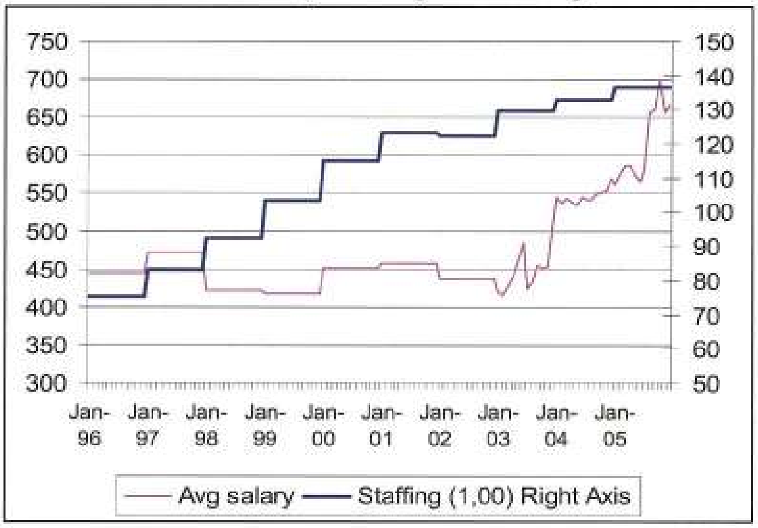
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Revenue	510	645	807	868	942	939	275	296	763	954	1,232
o/w Gross domestic	244	294	331	324	362	352	275	224	291	337	476
o/w Tax	144	208	213	228	248	241	183	141	167	191	231
o/w Nontax	100	86	118	97	114	111	92	82	124	146	245
o/w Gross clearance	266	352	476	544	580	587	0	72	472	617	757
Total expenditure (including net lending and VAT refunds)	578	781	862	838	937	1,212	1,119	1,022	1,292	1,528	1,994
Recurrent expenditure	578	781	862	838	937	1,199	1,095	994	1,067	1,320	1,594
o/w Wages	304	403	470	467	519	622	678	642	743	870	1,001
o/w Civil service	194	na	na	na	320	378	426	404	456	538	614
o/w Security services	110	na	na	na	199	244	252	239	288	333	387
o/w Nonwage expenditures	274	377	392	372	418	577	417	352	324	449	593
o/w Operating	na	na	na	na	na	na	na	na	124	193	179
o/w Transfers	na	na	na	na	na	na	na	na	201	257	375
o/w Debt service	13	10	9	16	17	7	–1	6	10	25	39
PA-financed capital expenditure	0	0	0	0	0	13	22	23	36	36	44
Balance	68	135	55	30	5	274	842	721	340	402	406
Net lending	0	0	0	0	0	0	0	0	173	157	344
VAT refunds	0	0	0	0	0	0	2	5	16	16	12
Overall balance	68	–135	–55	30	5	274	844	726	529	574	762

Source: Ministry of Finance, IMF, and World Bank staff estimates.

Despite the revenue crunch during the *intifada*, the PA's wage bill continued to increase at a rate of 11 percent a year between 1999 and 2005. Compared with the pre-*intifada* period, the increase was driven more by increases in average public sector salaries than by higher payroll numbers. Nevertheless, by the end of 2005, 137,000 persons were on the PA payroll, compared with 104,000 at the end of 1999, an average annual growth of 4.7 percent. The period 2003–05 witnessed two large salary hikes. The first occurred in late 2003 when part of the wage increase envisaged in the Civil Service Law, pending since 1998, was implemented. As a result, average wages in the first quarter of 2004 jumped more than 20 percent compared with levels a year before. There was another 20 percent increase in average salaries in the second half of 2005.

In the last quarter of 2005, the average salary for a PA employee reached $676 per month, up from $559 the year before, an increase of 21 percent (figure 1.7). The second round of salary increases disproportionately benefited security service staff relative to civil servants.[13] At the beginning of 2003 civil servants earned 20 percent more on average than security service staff. By the end of 2005 the difference had narrowed to less than 5 percent.

Figure 1.7: Palestinian Authority Staffing and Average Public Sector Salary



Note: The average salary is calculated by dividing the monthly wage bill with the year-end staffing levels; thus, the monthly variations in the average salary reflect wage bill variations and should be treated with some caution, though the trend is believed to be robust.
Source: Ministry of Finance, International Monetary Fund and World Bank staff calculations.

[13] Average wage numbers are subject to several uncertainties. First, monthly payroll data do not exist for the entire period. Only year-end data are available, and monthly data have been linearly interpolated from the annual data. Second, payroll data for the security services are particularly weak because the security service payroll is not fully controlled by the MOF. The quoted figures are based on MOF data; if payroll figures underreported the actual number of staff, the calculated average salaries would be similarly overestimated.

Since 2003 the PA has increasingly been the "financier of last resort" covering unmet financial obligations for other public entities, among them chiefly the following:

- The PA settles utility bills from Israeli suppliers that municipalities have not paid. Municipalities, in particular in the West Bank, are the main retail providers of water and electricity. These payments are "netted out" from the monthly transfer of Palestinian customs revenue and amounted to a total of $132 million in 2005 ($11 million a month).
- The PA has a contractual obligation to supply fuel for power generation by the Gaza Electricity Company, which cost $119 million in 2005 ($9 million a month).
- The PA must make payments to the Petroleum Commission, the PA owned monopoly importer of petroleum products. The Petroleum Commission sells its product at a loss, which has to be covered by the PA. In 2005 this amounted to $98 million, or $8 million a month (table 1.2).

Table 1.2: Net Lending in 2005
(millions of dollars)

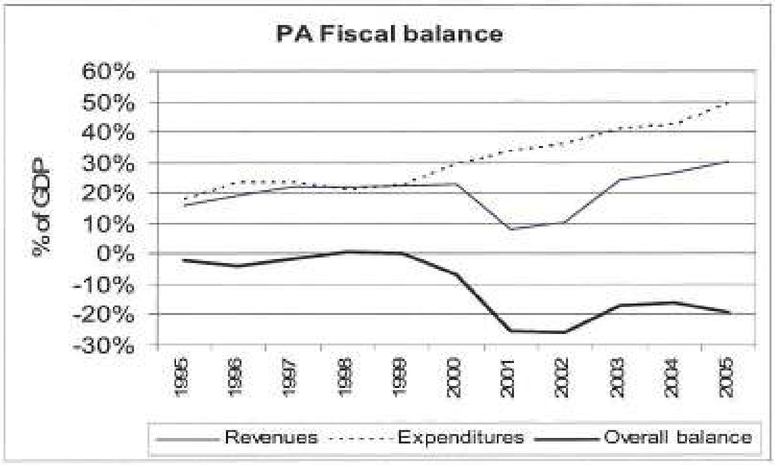
	Monthly	Annual
Deductions from clearance revenue by government of Israel	11.0	132
Electricity	8.3	100
Water	2.5	30
Sewage	0.2	2
Direct payments from PA	17.7	212
Gaza Electricity Company	9.9	119
Petroleum Commission	8.2	98
Other (negative number implies repayment to the PA)	–0.4	0.5]
Total	**29**	**344**

Source: Ministry of Finance, International Monetary Fund.

Continued expenditure expansion in the context of the economic crisis during the *intifada* resulted in a rapid increase in the expenditure-to-GDP ratio. By 2005 the ratio had more than doubled from its 1999 level of 22.6 percent to 49 percent, one of the highest ratios in the world. Of the 122 countries for which the World Development Indicators report central government expenditures, only Eritrea was higher, at 53 percent in 2004.[14]

[14] It should be noted that figures for other countries include capital expenditures, while the data for the PA does not.

Figure 1.8: Palestinian Authority Fiscal Balance



Source: Ministry of Finance, International Monetary Fund and World Bank staff estimates.

4. The Current Fiscal Crisis

The Palestinian Authority (PA) is experiencing an acute fiscal crisis.[15] During the first six months after the new Palestinian Government was sworn in, domestic tax revenues (on a cash basis) amounted to only $17 million per month, compared to $104 million during the same period a year earlier (table 1.3). Commercial banks significantly reduced their exposure to the PA government, mainly for fear of possible legal repercussions abroad. Banks reduced credit lines by offsetting their tax liabilities and by withholding other revenues accruing in the MOF's bank accounts against credit previously extended to the PA. Also, banks did not roll over loans falling due. The IMF estimates that bank loans to the PA were reduced by an average of $25 million per month between March and September 2006. By contrast, in the same period last year, commercial banks increased their lending to the PA by about $30 million a month. Outstanding PA debts to commercial banks (including banks abroad) as of end-September 2006, are estimated at about $500 million down from a peak of $695 million in February 2006.

[15] For a more in-depth analysis of the PA's fiscal crisis, see *Recent Fiscal and Financial Developments*, IMF, October 2006.

Table 1.3: Palestinian Authority Finances in the Second and Third Quarters of 2005 and 2006
(millions of dollars)

	Monthly averages		
	Q2–Q3 in 2005	Q2–Q3 in 2006	Change
Resources (net)			
Tax revenues (net)	104	17	–87
Domestic revenues	41	17	–24
Clearance revenues	63	0	–63
Domestic financing	50	–4	–53
Banks	31	–25	–56
Palestine Investment Fund	18	21	3
Previously withheld clearance revenues	9	0	–9
External financing	38	69	31
Total	192	83	–109
Expenditures			
Wages and allowances	81	45	–36
Transfers	34	4	–30
Operating and capital expenditures	27	9	–17
Net lending (subsidies)[1]	30	23	–7
Total	172	81	–90

1. In 2006, mostly fuel payments that do not include deductions from clearance revenues for payment of utilities supplied by Israeli companies.
Note: All figures are on a cash basis, though 2005 figures include some unpaid pension contribution commitments.
Source: IMF 2006.

The decline in revenues has partially been offset by an increase in external assistance. Donor financing to support the central government's recurrent budget operations amounted to $69 million a month in April–September 2006. This was significantly higher than the average of $38 million a month received in external support in the same period last year. Total support for the central government's recurrent budget operations in 2006 is estimated at $700 million, double the amount provided in 2005 ($350 million). The bulk of the external support came from Arab donors, who provided about $420 million, or an average of $47 million a month. An additional $164 million was channeled through the Temporary International Mechanism (TIM).

In such a tight liquidity situation, expenditure policy is reduced to the selection of which payments to make when funds become available (IMF 2006). The Palestinian Legislative Council initially extended the deadline for the submission of a 2006 budget until September 1, 2006, but this deadline was not met. Therefore, the PA government operates under the legal authorization to make monthly expenditures of up to one-twelfth

of 2005 expenditures.[16] All expenditure categories have been severely curtailed.[17] Salary and transfer payments were reduced by almost 60 percent, from $115 million in quarters 2 and 3 in 2005 to $45 million in the same period in 2006.[18]

On average, public sector employees have received payments of about 40 percent of their normal incomes. There have, however, been large differences between the various categories of employees, with the lowest-paid civil servants receiving up to 75 percent of their normal incomes while higher-paid employees received a much smaller fraction. Line ministries operating expenses were cut to a third of their level a year ago—$9 million a month in quarters 2 and 3 in 2006, compared to $27 million a month a year earlier.

Government finances have become increasingly fragmented and public finance reforms implemented in recent years are being compromised. Government receipts and expenditures, instead of being channeled through the Ministry of Finance's (MOF) Single Treasury Account, are now handled by several institutions, including the MOF (now only to a very limited extent), as well as the Office of the President and directly by international donors, via the TIM, or other sources outside the PA, such as the Palestine Investment Fund (PIF). As a consequence, reporting and transparency in public finance have deteriorated significantly.[19, 20]

In the absence of sharp corrections, the fiscal outlook is dire. A passive projection of fiscal trends suggests that the PA's fiscal deficit on a commitment basis could reach about $110 million a month, or about $1.3 billion (roughly 30 percent of GDP) on an annual basis—an amount unlikely to be fully covered by external support and domestic financing. Difficult political measures are needed to address the underlying problems and reduce the fiscal gap. The government urgently needs to reduce its wage bill, improve the collection of utility bills, eliminate the subsidization of petroleum products and streamline social transfers.

[16] The MOF sent out a budget circular for the preparation of the 2007 budget to ministries in August 2006, despite continuing uncertainties about future resource flows.

[17] Note that principal repayments to banks are treated as a (negative) financing item, reducing the envelope of available resources. But if debt service payments (principal and interest payments combined) were treated as an expenditure instead, this would be the second largest spending category, with an estimated $160–$170 million in debt service payments.

[18] Including the so-called Social Allowances paid under the TIM.

[19] The PIF is a public endowment fully controlled by and reporting to the President. Its Board of Directors are largely from the private sector.

[20] Any funds received in cash that have not entered any government accounts are difficult to track.

Box 1.2: Macro-Fiscal Policy Recommendations

Donors:

- Continued high levels of donor assistance are critical for sustaining Palestinian economy in the short term.
- In the short-term, reach agreement between the PA and major donors on a viable fiscal framework to be supported once aid flows resume, including an agreed upon strategy for containing the wage bill, reducing net lending and addressing major problems with pensions and transfer payments.
- Once the political situation improves, there should be an immediate resumption of Donor/PA dialogue on fiscal reforms, especially regarding implementation of a strategy for a sustainable PA wage bill. Donor support should flow in a timely and predictable manner consistent with the broader fiscal stabilization plan.

Government of Israel:

- Radical improvement in Palestinian movement of goods and persons is needed, including implementation of the 2005 *Agreement on Movement and Access*.
- Release clearance revenues directly to the PA and do not use them to settle arrears with private PA service providers prior to a careful inventory, verification and prioritization of outstanding arrears.

Palestinian Authority

- Put in place a high-level, emergency task force consisting of senior representatives from relevant ministries to develop a strategic plan for achieving a sustainable fiscal framework based upon a conservative, realistic set of revenue forecasts once the transfer of clearance revenues and traditional donor support resumes. Major work streams should include: (1) wage bill containment; (2) net lending; and (3) social transfers.
- Implement initial measures for containing the wage bill outlined in the civil service section, including a detailed personnel inventory, hiring freeze, and termination of ghost workers and double dippers. Develop strategic plan for reducing to the wage bill to approximately $80 million per month, including the possible roll-back of salaries, implementation of Voluntary Retirement Schemes and the like.
- Implement measures outlined in this chapter and the chapter on intergovernmental fiscal relations with regard to net lending, including gradually phasing out the subsidization of petroleum products; improving the collection of utility bills by municipalities; and moving from emergency assistance grants to performance based grants based on improvements in local revenue collection.
- Implement measures outlined in the chapter on social safety nets, particularly the redrafting of the pension law and, even more important, security services pension legislation.
- Relevant sector ministries to pursue efficiency gains outlined in individual PER chapters

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CHAPTER 2: PUBLIC FINANCIAL MANAGEMENT ISSUES

1. Key Issues and Challenges

The current position of public financial management (PFM) within the West Bank & Gaza is particularly difficult to characterize. On the one hand, it is an area where both the Palestinian Authority (PA) and the donor community have been heavily engaged for over a decade and a considerable stock of knowledge has been accumulated. The PA's accomplishments in the area of PFM until late 2004 were impressive, but more work clearly remained to be done. The bulk of the Public Expenditure Review (PER) PFM recommendations have been drafted with this ongoing agenda in mind, in the hope that they could help provide a way forward once direct donor funding to the PA resumed. But recent political developments have worked against a number of these accomplishments, as alternative mechanisms have been developed to channel resources to the Palestinian people that bypass many of the mechanisms that the PA and donors worked hard to create.

As noted in the Country Financial Accountability Assessment (CFAA) conducted by the World Bank during 2003/04, the PA made considerable progress between 2002 and 2004 towards the implementation of a Public Financial Management (PFM) system that provides adequate financial control and transparency. Important reforms were implemented, including:

- Setting up a Central Treasury Account through which all government revenue is collected and from which payments are made.

- Formulating an annual budget that is approved by the Palestinian Legislative Council and forms the basis for budget execution allocations.

- Putting into place a basic accounting system that provides a basis for orderly budget appropriations and budget execution.

- Establishing tight controls over expenditure through placing Ministry of Finance (MOF) financial controllers in spending ministries and agencies.

- Transferring payroll responsibilities to the MOF to improve the control of new recruitment and payment of all public sector salaries through bank accounts and ensure that all payees are in place and being paid correctly.

- Undertaking structural reforms to improve the operation and oversight of the PA's public enterprises and trading and investment activities through the establishment of the Palestine Investment Fund and restructuring of the Petroleum Commission and the government owned Cement Company.